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In the Supreme Court of the United States

OCTOBER TERM, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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In the Supreme Court of the United States

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No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment entered in this case by the United States Court of Appeals for the Third Circuit.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 51a-59a) are reported at 22 T. C. 440. The opinion of the Court of Appeals, which has not yet been officially reported, appears in the Appendix, *infra*, pp. 21-29.

JURISDICTION

The judgment of the Court of Appeals (Appendix, *infra*, pp. 29-30) was entered on June 9, 1955. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Where an employee is permitted to buy stock in his employer corporation at a price less than fair market value, is the resulting gain to the employee to be excluded from taxable income simply because the employer intended him to acquire a proprietary interest in its business?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

* * * * *

SEC. 29.22 (a)-1 [As amended by T. D. 5507, 1946-1 Cum. Bull. 18]. *What Included in Gross Income.*—Gross income includes in general compensation for personal and profes-

sional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * * *

If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. * * *

* * * * *

STATEMENT

From September, 1941, to February 28, 1947, the taxpayer was employed as manager of the New York sales division of the Michigan Chemical Corporation. There was no written contract covering the terms and conditions of his employment. The nature and extent of his duties remained the same throughout this period. He received a salary of $6,000 per annum in 1944 and 1945, and of $6,600 per annum in 1946 and 1947. (R. 51a.)

A plan to issue employee stock options had been approved at a meeting of Michigan Chemical Corporation's stockholders on March 21, 1944. Under the plan 10,000 shares of the corporation's common stock were to be made available to certain key employees of the corporation over the ensuing three years. At that time the fair market value of the stock was $4.50 a share and the option price was fixed at $5 a share. (R. 51a-52a.)

By a letter from the executive vice president of the corporation dated June 29, 1944, the taxpayer was informed of the terms and conditions of the employee stock option plan and of its purpose to provide an incentive to key employees and to permit them to participate in the success of the corporation. The taxpayer was congratulated on having been included in the list of those selected as competent to perform outstanding service and thereby participate in the future of the corporation. He

was advised that the allotment of stock to key men would be based on results accomplished and that monthly figures during the year would show the results of his efforts. Basic factors which should directly affect his accomplishments were enumerated and it was suggested that he select those areas in which he could make the greatest contribution. (R. 20a-22a.)

The taxpayer was granted the first non-transferable option covering 150 shares at $5 a share by letter from the executive vice president dated January 18, 1945. The fair market value of the stock in January, 1945, was $8.69 a share. (R. 54a.) The option could be exercised on June 30 of that year if the recipient was then still employed by the corporation. The taxpayer was advised that the allotment of 150 shares to him was in recognition of his contribution and efforts in making the operation of the corporation successful. He was told that further allotments would be recommended in accordance with the plan and that it was up to him to justify his participation in the plan during the next two years. (R. 23a-24a.)

The taxpayer was granted the second option to purchase under similar conditions an additional 150 shares at $5 a share by a letter from the executive vice president dated January 1, 1946. The fair market value of the stock in January, 1946, was $19.25 a share. (R. 54a.) The taxpayer was reminded that the extent of his participation in the plan was based on how well he handled his job during the year and that outstanding service to the

corporation was given added recognition in determining the number of shares assigned. He was told that it was only natural to expect a more rigid comparative appraisal of his efforts in the future; that any company was dependent upon its management and personnel for such success as might accrue to it; and that he was expected to contribute his share to the corporation's success. (R. 25a-26a.)

In 1946, upon exercise of the two employee stock options, the taxpayer received 300 shares of the corporation's stock for $8,100 less than its fair market value at that time. (R. 53a, 55a.)

The taxpayer was granted the third option to purchase an additional 40 shares under similar conditions by a letter from the president of the corporation dated January 2, 1947. The taxpayer was again advised that allocations, as in previous years, had been determined after a careful appraisal of the employee's contribution to the corporation's progress during the past year. The president congratulated the taxpayer on having earned this recognition given to him and expressed the trust that the taxpayer's future services, suggestions and interest in the corporation's welfare would warrant even greater recognition. (R. 26a-28a.)

In February, 1947, the taxpayer exercised this option and received an additional 40 shares of the corporation's stock for $580 less than its fair market value at that time. (R. 54a, 55a.)

In its income tax returns for 1946 and 1947, but not in 1945, the corporation deducted the amount of the difference between the option price at which

it sold stock to key employees during those years and the fair market value of that stock at such times. (R. 54a.)

The taxpayer's returns having failed to reflect his receipt or exercise of the employee stock options, the Commissioner issued a deficiency notice in which he determined that, when the taxpayer in 1946 and 1947 received his employer-corporation's stock for less than its fair market value through exercise of the employee stock options, the taxpayer realized taxable income in the nature of additional compensation in the amounts of $8,100 and $580, respectively. (R. 55a.) A petition for redetermination having been filed, the Tax Court entered a decision in favor of the taxpayer, concluding that the options had been granted to him not as additional compensation but to give him a proprietary interest in the corporation, and holding invalid Section 29.22(a)-1 of Treasury Regulations 111, as amended by T.D. 5507, 1946-1 Cum. Bull. 18, upon which the Commissioner relied. (R. 55a-59a, 60a.)

Agreeing that the Treasury regulation was invalid, the Third Circuit affirmed the Tax Court's decision. In reaching its conclusion, the Third Circuit reasoned (Appendix, *infra*, pp. 26-27) that, notwithstanding the broad definition of gross income contained in Section 22(a) of the Internal Revenue Code of 1939, a taxpayer upon exercise of an employee stock option could receive an immediate economic benefit which, although not a gift, would not constitute taxable income but would be

considered merely "incidental" if the intent of the employer-corporation in issuing the option was to have the taxpayer acquire a proprietary interest.

REASONS FOR GRANTING THE WRIT

This case presents an important question which should be decided by this Court, namely, whether a taxpayer's gain on acquisition of his employer corporation's stock for substantially less than its fair market value through the exercise of employee stock options, where it is found not to be a gift, constitutes taxable income. The question is of special importance and the decision of the Court of Appeals conflicts in principle with decisions of this Court, for the following reasons:

1. The granting of stock options as a means of conferring additional economic gain on corporate employees, particularly executives and other key officials, has become increasingly widespread in recent years. In no small part, the popularity of this corporate practice is attributable to decisions which, like that of the Court of Appeals in the instant case, permit the favored corporate official to receive this economic gain free of the same kind of tax burden borne by employees who receive their compensation in other forms. The tax-avoidance advantages of using employee stock options as an avenue by which ordinary income may take the attractive capital gain by-pass, thus enabling corporate executives to receive more take-home pay, have been widely publicized. The serious consequences to the revenue are obvious.

Recent surveys reveal that since 1950 approximately one out of every three sizeable companies having securities listed on the New York Stock Exchange has offered stock option plans to employees and that the use of such plans is still spreading. Stryker, Do Stock Options Pay, Fortune, December 1954, p. 118; Option Opulence, Wall Street Journal, February 1, 1955, p. 1. And, although actual statistics are not available, the practice among smaller corporations, such as the taxpayer in the instant case, which do not have securities listed on national stock exchanges appears to be equally widespread. Recent legal and trade periodicals contain numerous articles dealing with employee stock options.[1] In this modern alchemy of trans-

[1] These articles include: Miller, Capital Gains Taxation Of The Fruits Of Personal Effort: Before And Under The 1954 Code, 64 Yale L. J. 1 (Nov. 1954); McCarthy, A Survey Of Types Of Supplementary Compensation For Executives, 30 Taxes 878 (Nov. 1952); Lasser, How To Raise The Take-Home Pay Of High-Priced Help Under Today's Wage Freeze and Tax Laws, 93 Journal Of Accountancy 166 (Feb. 1952); Mahon, Corporate Tax Planning To Get Minimum Personal Tax Liability For Executives And Stockholders, 92 Journal of Accountancy 582 (Nov. 1951); Stryker, How Much Is An Executive Worth, Fortune, April 1955, p. 108; Bock, Tax-saving Opportunities In Deferred Compensation Under The New Revenue Code, 99 Journal of Accountancy 39 (March 1955); Garfinkle, Stock Option Plans For Executives, 41 Calif. L. Rev. 535 (Fall 1953); Gardner, Employee Stock Options, 50 Mich. L. Rev. 409 (Jan. 1952); Tarleau, The Problem Of Compensating Executives, Proceedings of Tax. Institute of So. Calif. School of Law, p. 149 (1953); Lentz, Stock Ownership Plans—Options, Warrants, Leverage Stock, Thirteenth Annual N. Y. U. Institute On Federal Taxation, p. 499 (1955); Lyon, Capital Gains Benefits Connected With Executive Retirement, Twelfth Annual N. Y. U. Institute on Federal Tax-

forming ordinary income into capital gains, one writer has enumerated 38 features which should be avoided in connection with employee stock option plans lest such options be classified as compensatory. Sax, Stock Options, 23 Taxes 505 (1945).

The facts of this case, then, do not represent an isolated factual situation. Nor is this an isolated decision. The Tax Court, where many of these cases originate, has taken the same position,[2] as have other Courts of Appeals in connection with a prior Treasury regulation.[3] Review by this Court is essential to bring the resolution of this issue into harmony with prior decisions of this Court and to

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ation, p. 365 (1954); Ivins, What Is New In Employee Stock Options, Tenth Annual N. Y. U. Institute on Federal Taxation, p. 121 (1952); Rudick, Compensation Of Executives Under the 1954 Code, 33 Taxes 7 (Jan. 1955); Leake, Compensating Executives And The Latest In Stock Options, 32 Taxes 488 (June 1954); Rice, Incentives For Executives of Small Corporations, 32 Taxes 222 (March 1954); Lyon, Employee Stock Purchase Arrangements, 31 Taxes 1021 (Dec. 1953); Landman, Executive Stock Options, 31 Taxes 735 (Sept. 1953); Lloyd, Relations Between The Corporation And Its Officers And Employees, 30 Taxes 546 (July 1952); Light, The Taxation Of Unrestricted Stock Options, 23 G.W. L. Rev. 329 (Jan. 1955); Taxation Of Compensatory Stock Options: Capital Gain Or Ordinary Income, 64 Yale L. J. 269 (Dec. 1954); Mann, Deferred Compensation And Stock Option Plans May Be Legal, But Are They Ethical, 93 Journal of Accountancy 324 (March 1952); Boland, Employee Options Under the Federal Income Tax, 28 Taxes 415 (May 1950).

[2] See, for example, *Bowen* v. *Commissioner*, decided July 22, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,207).

[3] See, for example, *Commissioner* v. *Straus*, 208 F. 2d 325 (C.A. 7th); *Commissioner* v. *Bradner*, 209 F. 2d 956 (C.A. 6th).

preserve the Congressional pattern for the taxation of income received by employees from stock option plans.

2. The decision below holds invalid Section 29.22 (a)-1 of Treasury Regulations 111, as amended by T.D. 5507, 1946-1 Cum. Bull. 18, *supra*, pp. 3-4. In so holding the Third Circuit has ruled that the definition of gross income contained in Section 22(a) of the Internal Revenue Code of 1939, *supra*, p. 2 (Sec. 61 of the Internal Revenue Code of 1954), is not broad enough to support a Treasury regulation requiring a taxpayer to report as taxable income the gain which he realizes when his employer transfers valuable property to him, otherwise than by gift, for less than its fair market value. The decision conflicts in principle with this Court's holding that in defining gross income it was "the intention of Congress to tax all gains except those specifically exempted." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430. See *Rutkin* v. *United States*, 343 U.S. 130, 139; *Commissioner* v. *Jacobson*, 336 U.S. 28, 49; *Helvering* v. *Bruun*, 309 U.S. 461, 468; *Helvering* v. *Clifford*, 309 U.S. 331, 334; *Douglas* v. *Willcuts*, 296 U.S. 1, 9; *Irwin* v. *Gavit*, 268 U.S. 161, 166; *Robertson* v. *United States*, 343 U.S. 711.

The Regulation in question represents long and studied efforts by the Treasury Department to state a rule which, in harmony with the broad Congressional purpose embodied in Section 22 (a) of the statute, will tax the employee with ordinary income when he realizes a gain conferred on him by

his corporate employer. Under the uniform rulings of this Court, such Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the statute which they interpret; they are not to be overruled except for weighty reasons. *Lykes* v. *United States*, 343 U.S. 118; *Commissioner* v. *South Texas Co.*, 333 U.S. 496; *Commissioner* v. *Wheeler*, 324 U.S. 542; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90; *Fawcus Machine Co.* v. *United States*, 282 U.S. 375; *Brewster* v. *Gage*, 280 U.S. 327; *Boske* v. *Comingore*, 177 U.S. 459.

The holding of the court below which invalidates this Treasury regulation is out of harmony with the decisions of this Court and raises questions of manifest importance to the revenue.

3. The Court of Appeals and the Tax Court have adopted an illogical, artificial test for determining when an employee receives taxable income upon exercise of an employee stock option. Thus, although recognizing that on exercise of such an option an employee receives an immediate economic benefit which is not a gift, the Court of Appeals nevertheless holds (*infra*, pp. 26-27) that that economic benefit does not constitute taxable income if the intent of the employer-corporation in issuing the option was that the employee acquire a proprietary interest.

Since, as the court below recognized, the employee received an immediate economic gain upon the exercise of the stock options and since, as the court below also recognized, the gain did not represent a gift or come within any other category of

income specifically exempted by Congress from taxation or specifically entitled to be taxed at different rates or at a different point of time, the conclusion seems inevitable that the gain realized by the employee falls within the broad sweep of Code Section 22 (a). *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426.

This realization of economic gain does not fall outside the scope of Section 22 (a) simply because, as described by the court below, it was received by the employee as a consequence of the employer's motive to enable the employee (Appendix, *infra*, p. 24) "to acquire a proprietary interest" as a stockholder. In the first place, the statute contains no justification for using such a motive as a reason for exempting the resulting gain from the broad coverage of Section 22 (a) or for granting preferential tax results to employees so situated. Secondly, there is no inconsistency between the employee's acquiring a proprietary interest and at the same time receiving taxable gain from the exercise of the stock option. Compensation to an employee can take the form of a grant of a proprietary interest. The latter does not negate the former. A corporation must necessarily intend any person to whom it sells its stock, by option or otherwise, to acquire a proprietary interest. In the case of employee stock options, where the acquisition of the stock interest is at a price less than that at which the corporation is willing to sell the stock to others, the employee obviously realizes a gain which is not available to others. However

sincerely the corporate employer hopes to benefit from its employees' acquisition of a proprietary interest in it, the incentive it offers its employees takes the form of economic gain. Since such offers are generally, and in the present case specifically, related to the services of the employees both past and future, the gain has all the indicia of compensation; and hence, unless it be found to be a gift, should be taxable as income. Cf. *Van Dusen* v. *Commissioner*, 166 F. 2d 647 (C.A. 9th). In a case like this, the simple fact is that the employees have received an immediate gain of measurable value. Therefore, unless it is shown to have the elements of a gift, the Regulations treating this gain as taxable income under Section 22(a) of the Internal Revenue Code are entirely proper, and their validity should be sustained.

4. The decision of the Court of Appeals, if its rationale is correct, will frustrate the purpose of Congress in enacting the restricted stock option provisions contained in Section 130A of the Internal Revenue Code of 1939, as added by Section 218 of the Revenue Act of 1950, c. 994, 64 Stat. 906, now reenacted as Section 421 of the Internal Revenue Code of 1954. When Congress enacted those restricted stock option provisions, it sought to give preferential tax treatment to employee stock options meeting certain prescribed qualifications and safeguards. See S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59-60 (1950-2 Cum. Bull. 483, 526). Under those provisions the tax on the gain realized by an employee when he acquires his employer cor-

poration's stock for less than its fair market value through the exercise of a restricted employee stock option is postponed until the employee sells the stock. At such time his gain [4] is taxed as ordinary income unless the option price was 95% or more of the fair market value of the stock when the option was issued. It will be noted that, even in the precise area where Congress has provided this carefully limited special treatment for employee stock options, the employer's intent to grant a "proprietary interest" is not a relevant factor in determining tax consequences.

The "proprietary interest" test, used by the Court of Appeals to justify its conclusion that no income is realized, is broad enough to defeat the Congressional purpose of granting some special tax benefits only where the prescribed conditions have been met. That is, if the Court of Appeals is correct in its conclusion that the economic gain conferred on the employee is not embraced by the all-inclusive definition of income contained in Section 22(a) where the motive is one of granting a proprietary interest, there will be no need for complying with the statutory safeguards in any other situation where a similar motive exists. And the vice of the decision below goes further—unlike the statutory provisions dealing with stock options which insure that the employee will eventually be

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[4] The amount of gain taxable as ordinary income is the difference between the option price and the fair market value of the stock when the option is granted or when the stock is disposed of, whichever is less.

taxed with *ordinary income* (except where the initial spread is less than five per cent), the decision of the Court of Appeals not only postpones the tax until the stock is sold, but has the effect of taxing the entire gain at that point as *capital gain* at preferential rates and of freeing his gain from any income tax whatsoever if the taxpayer dies without having sold the stock. In this respect, too, the decision below raises an important issue which should be settled by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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SEPTEMBER, 1955.

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 11,524

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

Argued May 3, 1955

Before Maris and Hastie, Circuit Judges, and Miller, District Judge

OPINION OF THE COURT—Filed June 9, 1955

By MARIS, *Circuit Judge:*

This case involves the taxability as compensation to the taxpayer of the difference between the purchase price and market value of stock in his employer, Michigan Chemical Corporation, which was acquired by him pursuant to stock options granted to him as an employee by that corporation. The facts are set out at length in the opinion of the Tax Court in this case, 22 T. C. 440, and need not be repeated here. Suffice it to say that the Commissioner of Internal Revenue determined a deficiency in income tax against the taxpayer for the years 1946 and 1947 with respect to stock of the

Michigan Chemical Corporation purchased by the taxpayer in each of those years at less than current market values pursuant to options previously given. The taxpayer petitioned the Tax Court for a redetermination of his tax liability. That court found that the options granted to the taxpayer "were to give him a proprietary interest in the corporation, and not as compensation for services," and concluded that no taxable gain was realized by the exercise of the options. The Commissioner here asks us to reverse this decision.

A virtually unbroken line of cases supports the Tax Court in holding that if the grant of a stock option by a corporation to its employee is intended as additional compensation to him the excess of the fair market value over the option price is income taxable to him when the option is exercised, but on the other hand if the grant of the option is intended to provide him with a proprietary interest in the business no taxable gain is recognized when the option is exercised, whether the grant of the option is the one or the other being in every case a question of fact.[1]

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[1] Durkee v. Welch, D.C.S.D. Calif. 1931, 49 F. 2d 339; Erksine v. Commissioner, 1932, 26 B.T.A. 147; Omaha Nat. Bank v. Commissioner of Internal Revenue, 8 Cir. 1935, 75 F. 2d 434; Rossheim v. Commissioner of Internal Revenue, 3 Cir. 1937, 92 F. 2d 247; Geeseman v. Commissioner, 1938, 38 B.T.A. 258; Evans v. Commissioner, 1938, 38 B.T.A. 1406; Adams v. Commissioner, 1939, 39 B.T.A. 387; Springford v. Commissioner, 1940, 41 B.T.A. 1001; Epsen v. Commissioner, 1941, 44 B.T.A. 322; Connolly's Estate v. Commissioner of Internal Revenue, 6 Cir. 1943, 135 F. 2d 64; Landen v. Commissioner, 1943, 1 TCM 411; Lamond v. Commissioner, 1946, 5 TCM 51; Nicolson v. Commissioner, 1949, 13 T.C. 690;

The Commissioner asserts, nonetheless, that this is not the law, but that Commissioner v. Smith, 1945, 324 U.S. 177, and section 29.22(a)-1 of Regulations 111, as amended by T.D. 5507 (1946-1 Cum. Bull. 18) following the decision in the Smith case, compel the conclusion that taxable income results whenever a stock option given by a corporation to an employee is exercised at an option price less than fair market value, the option not being a gift.

In the Smith case there was no doubt as to the stock option having been given to the employee as compensation. It was so found by the Tax Court and the finding of that court was upheld by the Supreme Court. The sole question was whether taxable income was realized at the time that the option thus given as compensation was exercised. The Supreme Court held that it was, saying (p. 181):

> "Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

It will be seen that the Smith case does not hold that the exercise of any stock option given to an

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Clark v. Commissioner, 1950, 9 TCM 719; Commissioner of Internal Revenue v. Bradner, 6 Cir. 1953, 209 F. 2d 956, affirming 11 TCM 566; McNamara v. Commissioner, 1953, 19 T.C. 1001, 1009, rev. on other grounds, 7 Cir., 210 F. 2d 505; Rosenberg v. Commissioner, 1953, 20 T.C. 5; Hazelton v. Commissioner, 1953, 12 TCM 398; Noland v. Commissioner, 1953, 12 TCM 1003; Commissioner of Internal Revenue v. Straus, 7 Cir. 1953, 208 F. 2d 325.

employee may result in taxable gain to him when exercised even though the option was given to enable him to acquire a proprietary interest in the corporation and not as compensation.

Nonetheless the Commissioner, shortly after the decision of the Smith case, by T.D. 5507 amended the regulations so as to read:

> "If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value *is in the nature of compensation* and shall be included in the gross income of the employee." (Emphasis supplied).

The amendment dropped from the regulation the former qualifying clause which read: "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered." By I.T. 3795 (1946-1 Cum. Bull. 15) the amendment made by T.D. 5507 was held to be applicable to stock options granted by corporations to their employees on and after February 26, 1945, the date of the Supreme Court's decision in the Smith case.

While the Commissioner has heretofore stated that this change in his regulations was based upon the decision in the Smith case he now abandons that position and asserts that the amendment does not go beyond the scope of section 22(a) of the

Internal Revenue Code of 1939 and is, therefore, valid and binding as eliminating any middle nontaxable ground in these cases between a pure gift on the one hand and an economic benefit which must be treated taxwise as compensation on the other. We agree with the Commissioner that the decision in the Smith case does not support the amendment made by T.D. 5507 even though it was the ostensible basis for it. But we cannot agree that section 22(a) supports the amendment in compelling any economic benefit derived by a corporation's employee from the exercise of a stock option to be treated as compensation and taxable as such regardless of whether or not it was so intended.

Section 29.22(a)-1 of the regulations as it stood before the amendment [2] was itself a recognition by the Commissioner when he adopted it in 1939 that section 22(a) of the Internal Revenue Code did not include in gross income for purposes of income tax the entire economic benefit received by a corporation's employee upon every purchase of stock for less than its fair market value, but only to the extent that such benefit was in the nature of compensation. In so providing the Commissioner abandoned a regulation,[3] similar to his present one, thereby acceding to judicial authority which refused to uphold that position.[4] The regulation

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[2] T.D. 4879, 1939-1 Cum. Bull. 159.

[3] T.D. 3435, II-1 Cum. Bull. 50 (1923).

[4] Taplin v. Commissioner of Internal Revenue, 6 Cir. 1930, 41 F. 2d 454; Commissioner of Internal Revenue v. Van Vorst,

thus adopted in 1939 in response to the rulings of the courts has itself been applied with approval [5] and we think that it, and not the amendment effected in 1946 by T.D. 5507, conformed to section 22(a) of the Code.

It is denying the facts of economic life to assert that every grant of a stock option to a corporation's employee is necessarily additional compensation to the extent that at the time of exercise the market value of the stock exceeds the option price. For it is a well known and common practice of American business corporations to seek to retain the continued interest in the business of their key employees by inducing them through favorable stock options to acquire a proprietary interest as stockholders. In a great many such cases the immediate economic benefit to the employee is minor, incidental and, often, quite fortuitous. Such transactions are, however, not gifts for there is a very real consideration to the corporation, the continued interest of a key employee. There are, of course, other cases in which the element of compensation is the important one. But the fact that there is an ele-

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9 Cir. 1932, 59 F. 2d 677; Rossheim v. Commissioner of Internal Revenue, 3 Cir. 1937, 92 F. 2d 247; Geeseman v. Commissioner, 1938, 38 B.T.A. 258; Evans v. Commissioner, 1938, 38 B.T.A. 1406; Adams v. Commissioner, 1939, 39 B.T.A. 387; Springford v. Commissioner, 1940, 41 B.T.A. 1001; Hawke v. Commissioner, 9 Cir. 1940, 109 F. 2d 946, cert. den. 311 U.S. 657.

[5] Commissioner of Internal Revenue v. Straus, 7 Cir. 1953, 208 F. 2d 325.

ment of immediate economic benefit does not exclude the conclusion that the option was given solely to provide the employee with a proprietary interest and that the immediate benefit was purely incidental and not compensatory.

We are in accord with the statement by Judge Turner in his opinion in Geeseman v. Commissioner, 38 B.T.A. 258, 263-264, in which the Commissioner acquiesced (1939-1 Cum. Bull. 13), that:

> "To hold that a transaction of the character here involved is a 'bargain' purchase having nothing to do with the employer-employee relationship, or, to the contrary, that it is not a purchase but constitutes the receipt of compensation having nothing to do with the purchase of property, to the extent that the fair market value exceeds the purchase price, is to ignore obvious facts and to assume a case substantially different from the one before us. In the first place, it may not be said that the acquisition of the stock of Continental Can Co. was not a purchase merely because the price paid was substantially lower than the price at which the same stock was then selling on the market, and, in the second place, obvious facts are ignored if it be said that the stock transaction was separate and apart from, or was not based upon, the employer-employee relationship, or that it had no relation to services rendered or to be rendered. In practically

all such cases both elements are present and decision is impossible if the absence of one or the other is essential thereto.

"Normally the purchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale, and upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital. . . . Accordingly it is our opinion that as a prerequisite to the conclusion sought by the respondent it should definitely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered."

In the present case, as we have said, the Tax Court found as a fact that the options granted to the taxpayer by the Michigan Chemical Corporation "were to give him a proprietary interest in the corporation, and not as compensation for services." This was a factual issue which it was the peculiar responsibility of the Tax Court to resolve. From our examination of the evidence we cannot say that its finding was clearly erroneous.

The decision of the Tax Court will be affirmed.

A true Copy:

Teste:

_____,

Clerk of the United States
Court of Appeals
for the Third Circuit.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 11,524

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

PHILIP J. LOBUE, RESPONDENT

On Petition to Review a Decision of the Tax Court of the United States

Present: MARIS and HASTIE, Circuit Judges, and MILLER, District Judge.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the de-

cision of the said Tax Court in this cause be, and the same is hereby affirmed.

Attest:
IDA O. CRESKOFF,
Clerk.

June 9, 1955.

Received & Filed June 9, 1955.
IDA O. CRESKOFF,
Clerk.

★ U. S. GOVERNMENT PRINTING OFFICE: 1955 284283 286